Internal Revenue Service
memorandum
CC:TL-N-1231-91
TS/P/JROSENBERG/alb

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to: District Counsel, San Jose CC:W:SJ
. Attn: Steve Wilson

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]
TL-N-1231-91
CC:TL:TS/P Rosenberg Sabin
I.R.C. § 6241; Temp. Treas. Reg. § 301.6241-1T(c)(2)

This memorandum is in response to your request for tax litigation advice dated November 6, 1990.

ISSUE

Whether in determining if an S corporation is subject to the small S corporation exception to the subchapter S audit and litigation procedures of I.R.C. §§ 6241 through 6245, the Service must rely solely upon the information reported on the Schedule K-1s or whether a facts and circumstances test controls.

CONCLUSION

A facts and circumstances test controls whether the small S Corporation exception applies, except with respect to whether the "same share" test is met. Thus, with respect to whether a partner or shareholder is a pass-through shareholder for purposes of Temp. Treas. Reg. § 6241-1T(c)(iii), the Service must conduct a facts and circumstances test. Accordingly, since the Service has obtained information to establish that the true shareholder of [redacted] is a trust and not a natural person, pursuant to Temp. Treas. Reg. § 301.6241-1T(c)(iii), [redacted] would be subject to the subchapter S unified audit and litigation procedures of sections 6221 through 6245, and thus, a notice of FSAA must be issued.

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FACTS

[redacted] (hereinafter [redacted]) was incorporated in [redacted] apparently under subchapter C of Chapter 1 of the Internal Revenue Code. [redacted] acquired all of the stock of [redacted] ([redacted] shares at $[redacted] par value) in [redacted]. On [redacted], [redacted] transferred all [redacted] shares of [redacted] to the [redacted]. On [redacted], the corporation was converted to a subchapter S corporation.

The sole K-1 attached to [redacted]'s return for the period ended [redacted], indicates that [redacted] owns [redacted]% of the entity's [redacted] shares. The [redacted] federal tax return makes no mention of the trust. [redacted]'s [redacted] federal tax return also lists [redacted] as the [redacted]% shareholder of the entity.

DISCUSSION

The Subchapter S Revision Act of 1982 added the S corporation audit and litigation procedures of I.R.C. §§ 6241 through 6244 to the Internal Revenue Code to provide a method for unified treatment of subchapter S items among the shareholders. I.R.C. § 6241 provides that, "[e]xcept as otherwise provided in regulations prescribed by the Secretary, the tax treatment of any subchapter S item shall be determined at the corporate level."

Section 6244 makes the small partnership exception of section 6231(a)(1)(B)(i) applicable to S corporations except to the extent modified or made inapplicable by regulations. See Blanco Investments v. Commissioner, 89 T.C. 1243 (1987). Section 6231(a)(1)(B)(i) defines a small partnership as a partnership in which, (1) there are ten or fewer partners; (2) each partner is a natural person (not a nonresident alien) or an estate; and (3) each partner's share of each partnership item is the same as his or her share of every other partnership item.

Temp. Treas. Reg. § 301.6241-1T(c) modifies the small entity exception as it applies to subchapter S corporations as follows:

> (c) S corporation--(1) In general. For purposes of subchapter D of chapter 63 of the Code, except as provided in paragraph (c)(2) of this section the term "S corporation" means any corporation required to file a return under section 6037(a).
>
> (2) Exception for small S corporations--(i) Effective date. This paragraph (c)(2) shall apply to any taxable year of an S corporation the due date of the return for which (determined without

regard to extensions) is on or after January 30, 1987.

(ii) Five or few shareholders. For purposes of this paragraph (c), an S corporation shall not include a small S corporation. A small S corporation is defined as an S corporation with 5 or fewer shareholders, each of whom is a natural person or an estate. For purposes of this paragraph (c)(2), a husband and wife (and their estates) are treated as one shareholder. If stock (owned other than by a husband and wife) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is considered to be a shareholder of the corporation. . .

(iii) Special rule. The exception provided in paragraph (c)(2)(ii) of this section does not apply to an S corporation for a taxable year if any shareholder in the corporation during that taxable year is a pass-through shareholder. For purposes of this paragraph (c)(2)(iii), a pass-through shareholder is--

(A) <u>A trust</u>
(B) A nominee, or
(C) Other similar pass-through persons through whom other persons have an ownership interest in the stock of the S corporation. (Emphasis supplied)

For purposes of the preceding sentence, a shareholder's estate shall not be treated as a pass-through shareholder.

The above regulation is effective for taxable years, the return for which is due on or after January 30, 1987.

The issue in light of the above-stated regulation is whether the information reported on the Form K-1 as to the proper shareholder is dispositive of whether any are pass-through shareholders. If the Form K-1 attached to [redacted]'s [redacted] federal tax return is dispositive, [redacted] would fall within the small S corporation exception of Temp. Treas. Reg. § 301.6241-1T(c)(2)(ii) since the K-1 indicates that it is comprised of a single individual shareholder. However, if the Service may use additional information to determine the true shareholders of [redacted], then under Temp. Treas. Reg. § 301.6241-1T(c)(2)(iii), [redacted] would be excluded from the small S corporation exception since its sole shareholder is a trust.

In Z-Tron Computer Research and Development v. Commissioner, 91 T.C. 258 (1988) and Harrell v. Commissioner, 91 T.C. 242 (1988), the Tax Court held that the determination of whether the same share requirement of the small partnership exception is met is determined by the information reported on the Form K-1. The holding was expressly limited to the application of the same share requirement, however. Thus, the Tax Litigation Division has expressly limited the use of such a bright line test to the same share requirement. This decision has been made in part due to pratical considerations. For instance, a name on a Form K-1 may be ambiguous and not clearly indicate the character of a partner as a natural person or entity. Furthermore, Congress has expressed a preference that the tax consequences to an indirect partner holding an interest through a pass-through partner should be determined at a source partnership proceeding. See Sente Investment v. Commissioner, 95 T.C. No. 19 (Sept. 11, 1990). Similarly, the number of Form K-1's will not be dispositive as to whether the partnership has more than ten partners at any one time during the taxable year for purposes of section 6231(a)(1)(B)(i)(I). Sales or exchanges of interest may have occured during the taxable year resulting in more than ten Form K-1s even though there were never more than ten partners at any one time. Therefore, as in the partnership context, the Service will not rely solely upon the Schedule K-1s in determining the number of shareholders in an S corporation or whether the shareholders are natural persons. Instead the Service should conduct a facts and circumstances test. Accordingly, we conclude that since the revenue agent has obtained information to establish that the true shareholder of [redacted] is a trust and not a natural person, pursuant to Temp. Treas. Reg. § 301.6241-1T(c)(iii), [redacted] would be subject to the subchapter S unified audit and litigation procedures of sections 6221 through 6245. A notice of FSAA should, therefore, be issued.

Additionally, we note that in your memorandum requesting this tax litigation advice you state that the Tax Court's recent decision in Hang v. Commissioner, 95 T.C. No. 6 (July 18, 1990), may raise an issue as to whether the Service can look beyond the shareholders of record in determining whether an S corporation qualifies as a small S corporation and, thus, is exempt from the unified audit and litigation procedures. In Hang, the Tax Court held that reallocation of income from a shareholder of record to the beneficial owner was not a subchapter S item and therefore, was not properly included in a notice of FSAA. Notwithstanding the fact that we have filed a motion for reconsideration of the Court's decision, we believe the facts of this case are distinguishable from Hang. This is because in Hang there was never an actual transfer of the S corporation interest from the purported shareholders of record to the beneficial owners, whereas in the present case, there was such an actual transfer of the interest. In addition, because of the Court's holding regarding the reallocation issue, the Court in Hang never addressed the issue of whether the S corporation was subject to the small S corporation exception. Accordingly, we find nothing in Hang that would preclude the Service in this case, from looking beyond the Form K-1s in determining the true shareholders of record.

Should you have any further questions regarding this matter, please contact Jeffrey Rosenberg at (FTS) 566-3233.

MARLENE GROSS

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